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No. 80-2053

In the Supreme Court of the United States

OCTOBER TERM, 1980

J. NAT HAMRICK, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The question presented by the petition in this federal income tax case is whether the decision below correctly held that the loss claimed by petitioner [1] arising from the mortgagee's foreclosure on her property which she had encumbered to secure loans to her family-owned corporation was a nonbusiness bad

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[1] References to "petitioner" are to Jenice Hamrick. J. Nat Hamrick, petitioner's husband, is a party only because he filed a joint income tax return with his wife for the years in question.

debt, deductible only as a short-term capital loss, and correctly determined the amount of that loss.

The pertinent facts may be summarized as follows: On December 7, 1920, petitioner's father conveyed by deed of gift a large tract of farm land to petitioner's mother, who mortgaged the property to secure the debts of the family-owned corporation. Subsequently, in 1966, petitioner's mother made a gift of the property, still subject to the pre-existing mortgage, dividing it equally between petitioner and petitioner's brother and reserving to herself a life estate in the property. In 1967, petitioner executed a second mortgage on her one-half interest in the property, as collateral for loans made to her family-owned corporation.[2] Pursuant to an informal arrangement, the corporation, under the direction of taxpayer's brother, farmed this property without paying any rent to petitioner. In 1970, the mortgagee foreclosed on the property, and purchased it at a foreclosure sale for $200,000 (Pet. App. 6-9).

On her income tax return for 1970, petitioner claimed an ordinary loss deduction of $170,000 attributable to the loss on the foreclosure sale of her one-half interest in the property. On audit, the Commissioner of Internal Revenue reduced petitioner's loss on the sale of the property to $32,180, and determined that it was deductible as a long-term capital loss (Pet. App. 9-10). In this proceeding brought by petitioner to redetermine the ensuing deficiencies, the Tax Court characterized the transaction, in which petitioner mortgaged her property for the corporation's debts, not as a sale but as tantamount to a guaranty of those debts, giving rise to subrogation upon the

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[2] Petitioner owned 41% of the corporation's capital stock, while her mother and brother owned the remainder (Pet. App. 9).

ultimate foreclosure by the mortgagee (Pet. App. 12-13). The Tax Court accordingly ruled that the loss suffered by petitioner because of the corporation's inability to repay the obligation arose from the worthlessness of a nonbusiness bad debt pursuant to Section 166(d) of the Internal Revenue Code of 1954 (26 U.S.C.), and that it was therefore deductible only as a short-term capital loss (Pet. App. 12-21).

The Tax Court also accepted the testimony of the Commissioner's expert witness that the value of the property on December 7, 1920, which provided the basis for determining the amount of petitioner's loss, was $85 per acre, rather than the $250 per acre urged by petitioner. Accordingly, it computed petitioner's loss to be $39,780 (Pet. App. 21-27). The court of appeals affirmed per curiam, on the basis of the Tax Court's opinion (Pet. App. 1-3).

1. The decision below correctly held that petitioner's loss on the foreclosure of the mortgage was deductible only as a short-term capital loss.

As both courts below found, petitioner was in substance a guarantor who became subrogated to the rights of the creditor upon payment of the guaranteed debt. In these circumstances, it is clear that any loss sustained by petitioner stems from the worthlessness of that debt in her hands. *Putnam* v. *Commissioner*, 352 U.S. 82, 88-89 (1956). Such a loss is subject to the provisions governing the deductibility of bad debts set forth in Section 166 of the Internal Revenue Code of 1954. Further, a bad debt loss is deductible as such or not at all. *Putnam* v. *Commissioner, supra.*[3] While bad debts proximately related

[3] Petitioner errs in her reliance (Pet. 3, 9-10, 16) on *Fox* v. *Commissioner*, 190 F.2d 101 (2d Cir. 1951), *Patterson* v. *United States*, 459 F.2d 487 (Ct. Cl. 1972), and *Mercer* v.

to the taxpayer's trade or business are deductible in full against ordinary income (Section 1.166-5(b), Treasury Regulations on Income Tax (26 C.F.R.)), a taxpayer is limited to short-term capital loss treatment for a nonbusiness bad debt under Section 166(d) of the Code. See *United States* v. *Generes*, 405 U.S. 93, 103 (1972).

Here, petitioner was a guarantor of the corporation's borrowing, to the extent that she pledged her property for its debts. There was, however, no evidence that she engaged in any trade or business, much less one that was proximately related to her guaranty of the corporation's debt. The corporation, not petitioner, pursued the trade or business of farming, and the business of a corporation is generally not imputed to that of its shareholders for purposes of taxation. *Whipple* v. *Commissioner*, 373 U.S. 193, 202-203 (1963); *Burnet* v. *Clark*, 287 U.S. 410, 415 (1932); *Dalton* v. *Bowers*, 287 U.S. 404, 410 (1932). Moreover, petitioner was not engaged in the trade or business of renting property; indeed, she neither executed any type of rental agreement with the corporation for the use of her property, nor collected even a nominal rent. See *Yanow* v. *Commissioner*, 44 T.C. 444 (1965), aff'd per curiam, 358 F.2d 743 (3d Cir. 1966). Accordingly, peti-

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Commissioner, 376 F.2d 708 (9th Cir. 1967), to support her contention that she suffered a loss under Section 165(c) of the Code. First, this Court in *Putnam* (352 U.S. at 93 n.21) expressly discredited, if it did not overrule, *Fox*. Further, neither *Patterson* nor *Mercer* involved a bad debt, and the holder of a bad debt, like petitioner, may not elect alternatively to claim an ordinary loss deduction under Section 165. See *Putnam* v. *Commissioner*, *supra*; *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 189 (1934).

tioner's loss was a nonbusiness bad debt under Section 166(d) of the Code.[4]

3. The parties below treated petitioner's basis in the farm property transferred in satisfaction of the guaranty obligation as her basis in the debt. Moreover, it has been undisputed that the basis of petitioner's one-half interest in the farm property was derived from its fair market value on December 7, 1920, the date on which petitioner's mother acquired the property by gift from petitioner's father. See Sections 1015(a) and (c) of the Code.

Petitioner contends (Pet. 23-29) that the property was then worth $250 per acre and not $85 per acre, as determined by the Tax Court. But the Tax Court's factual determination (see *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960)) was based on the testimony of the Commissioner's expert witness, who carefully examined the sales of comparable farmland in the surrounding area between 1919 and 1922. Such a method of realty valuation has been widely upheld. See, *e.g.*, *Madison Gas & Electric Co.* v. *Commissioner*, 72 T.C. 521, 569 (1979), aff'd on another issue, 633 F.2d 512 (7th Cir. 1980). Petitioner's witnesses, on the other hand, lacked any expertise in assessing the value of real estate, and their opinions were not grounded on objective facts. Moreover, contrary to petitioner's suggestion (Pet. 23-24), the

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[4] *Schlumberger Technology Corp.* v. *United States*, 443 F.2d 1115 (5th Cir. 1971), *Trent* v. *United States*, 291 F.2d 669 (2d Cir. 1961), *Mays* v. *Commissioner*, 272 F.2d 788 (6th Cir. 1959), and *Giblin* v. *Commissioner*, 227 F.2d 692 (5th Cir. 1955), involving bad debts and upon which petitioner also relies (Pet. 19-22), are inapposite. In each of those cases, it was determined that the loans made were connected with the taxpayer's trade or business. Here, however, petitioner was not engaged in a trade or business.

Commissioner's expert witness properly excluded from his calculations the improvements situated on the property because they had been fully depreciated by the corporation prior to the year of the loss. See Section 1016(a)(2) of the Code. The Tax Court therefore correctly determined the value of petitioner's one-half interest in the property as of December 7, 1920.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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